BEAR
STEARNS

Bear, Stearns & Co. Inc.
383 Madison Avenue
New York, NY 10179
Tel (212) 272-2000
www.bearstearns.com

January 27, 2005

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re. File No. S7-10-04 – Regulation NMS; Release No. 34-50870

Dear Mr. Katz:

Bear, Stearns & Co. Inc. welcomes the opportunity to comment on the Commission's latest Regulation NMS proposal.[1] We commend the Commission for republishing Regulation NMS in its revised form and providing the public with an additional opportunity to review the details before the Commission takes final action. This was an important and necessary step given some of the significant modifications included in the latest proposal (the "Reproposal"). We would also like to acknowledge that the Reproposal reflects an extensive amount of work, thought and effort to solicit and incorporate public comments from a vast number of sources. We are hopeful that the proposed rules will be able to help alleviate some of the outstanding problems currently hampering the operation of the US equity markets. However, to ensure an optimal outcome, there are some important areas where modifications should be made, as outlined below.

Our comments on the Reproposal are limited to the following four points:

1. Regarding trade through reform, of the two proposals presented, the Market BBO alternative, if properly modified, could bring tangible benefits to the U.S. equity markets, whereas Depth of Book (DOB) protection would do more harm than good.
2. Rule 611 should provide an exception for 'Stopped' orders, given the frequency with which 'stopped' orders are printed without any direct relationship to the quoted price of a stock at the time of execution.
3. Rule 611 should provide an explicit "Arbitrage Exception" covering various forms of index, merger arbitrage, and derivative hedging transactions.
4. Under Rule 600(b)(57), the definition of "protected bid" or "protected offer" should be modified to include "manual quotations" as defined by Rule 600(b)(37) when applied to designated "illiquid securities."

Additional detail supporting these comments is provided below.

[1] Securities Exchange Act Release No. 34-50870 (May 26, 2004) 17 CFR Parts 200,201, 230, et al. (the "Reproposal"), following Securities Exchange Act Release No. 49325 (February 26, 2005) 69 FR 11126 (the "Proposing Release"); and, Securities Exchange Act Release No. 49749 (May 26, 2004) 69 FR 30142 (the "Supplemental Release").

Detailed Comments

For the preponderance of trading activity in the marketplace, we support the framework for trade through reform in the Reproposal and conditionally support the Market BBO alternative, clearly the superior of the two alternatives proposed.

There are several potential options for trade through protection that range from Depth of Book (DOB) protection to NBBO-only protection. In our view, a determination about the most appropriate level of trade through protection requires intelligent and controlled government regulation balanced by consideration of competitive market forces. We believe that top of book (TOB) protection (the Market BBO alternative) accomplishes the right balance for trade through protection because it encourages competitive quoting behavior both within and among markets, without imposing excessive routing obligations and related costs on receiving trading centers. As a result, while we believe that a mandate for TOB protection serves a useful public good, we believe that the practice of sweeping the depth of multiple books is a value-added proposition best driven by competitive forces and best execution considerations among broker-dealers and order routing services, and should not be an obligation of trading centers receiving orders from their customers.

Some of our reasons for opposing DOB protection are outlined in our letter to the Commission dated November 23, 2004, and we encourage the Commission to include these comments in their consideration of the Reproposal. In addition to those comments, we would like to add that the DOB proposal would not effectively achieve its stated objective of protecting displayed orders. The Reproposal recognizes that "under the priority rules currently in effect at electronic markets, undisplayed size has priority over displayed size at an inferior price." An example is provided in the Reproposal[2] that reveals that a market attempting to execute against displayed orders in another market would trade with reserve orders before displayed orders at inferior prices. As a result, it is likely that non-displayed reserve orders would benefit most from the DOB alternative. This outcome would not promote limit order display and would occur unless market centers create the ability for other markets to ‘sweep’ displayed orders only, an alternative that raises new questions about the importance and usefulness of reserve orders.

Despite our general support for the Market BBO alternative, we have significant concerns and suggested modifications (outlined below) based upon the fact that all stocks do not trade the same way and, similarly, trading strategies and services vary greatly. To optimally capture the value of a trade through rule without unnecessarily hurting the liquidity provision process, Rule 611 and related parts of the Reproposal must better account for these differences. Specifically, the Market BBO alternative and related accessibility standards require modification as applied to “stopped orders,” arbitrage and hedging transactions, and illiquid securities. These modifications are consistent with and integral to the SEC’s philosophy of fostering trading activities that make our markets more orderly, more liquid and more efficient.

Rule 611 should provide an exception for “Stopped Orders”

The use of “stopped orders” is an important part of the liquidity provision process for institutional customers. When a broker-dealer (BD) offers a customer a “stop,” the BD is entering into a contractual agreement with that customer which involves taking on principal risk. This process enables institutional customers to get a guaranteed fill for large orders at a specified price based on prevailing markets (which includes the current NBBO, but also often takes into consideration recent trading ranges and volume weighted average prices). This ability is otherwise not possible through purely electronic interaction with ECNs and electronic markets. In fulfilling this agreement, sometimes the BD is able to access liquidity within the market at a price at or better than the stop price (usually passing on the price-

[2] See the Reproposal, p. 67.

improvement to the customer); sometimes the broker-dealer accesses liquidity in the marketplace at a final price that is inferior to the stop price (which results in a loss to the BD). This process can be concluded in a matter of minutes or could take several hours. In addition, this process could be done with a “straight stop” (wherein the BD must trade principally for all executions beyond the agreed upon stop price) or with an “average price stop” (wherein the BD can provide the customer with executions both above and below the stop price, as long as the average price is at or better than the stop price. Regardless, two factors are important to note:

1) In either case, the BD is directly accessing the national market system in the course of executing the customer’s order; and

2) The stop price, at the time it is printed, is usually away from the prevailing NBBO quote. This is not due to ignoring the NBBO or other displayed liquidity in the national market system. It is, instead, a result of a time lag between the time the “stop” was priced and the completion of the order being worked/executed in the marketplace. The price gap is generally more pronounced for average price stops than for straight stops.

The “stop exception” should apply to all “stops” in which (a) the full contra-side to the customer order is filled via trading in the national market system, and (b) the prevailing NBBO price varies from the stop price at the time of the customer’s print.

Rule 611 should provide an “Arbitrage Exception”[3]

There are a number of transaction types which trade to a "spread" relationship between two assets rather than absolute prices of either. As such, investors implementing this type of strategy are interested in the best execution for and liquidity of the package rather than its components. Unfortunately, as written, Rule 611 would require one or more of the components of some spread trades to be separately executed. This would prevent investors from receiving timely complete executions of the package, since the sum of the separately-routed components could be less than the whole for which investors are seeking execution and liquidity. We believe that a Rule 611 “Arbitrage Exception” should include the following:

(i) rebalancing of proprietary long or short positions in stocks underlying broad-based indices, that is, indices involving 20 or more stocks, where the sponsor of the index is changing the composition of the index (either the stocks included or the weighting, or both);

(ii) the unwinding or establishing of an arbitrage between a derivative or an exchange-traded fund (an "ETF"), such as the "QQQ" ETF, and a portfolio consisting of all, or a representative sample, of the stocks underlying the derivative or ETF, including:
   a. any hedged transactions involving ETFs, which should be exempt due to the fact that the pricing of ETFs is largely related to or determined by the offsetting transactions in futures, baskets of stocks or other derivatives, and
   b. swaps and forward transactions that are hedged using stocks or ETFs, for which the same logic applies.

We further suggest the exception should apply equally to both convertible securities and "exchangeable" securities, that is, securities exchangeable for securities of a different issuer. A well-developed market exists for spread orders and executions in a wide range of convertible securities with common stock hedges simultaneously executed. The

---

[3] Certain text from this section is taken from the SEC Comment Letter of Roger D. Blanc of JP Morgan Securities, dated January 30, 2004, commenting on Proposed Regulation SHO; File No. S7-23-03.

relationship is known and specified at the time of the order, and the relationship stands regardless of the prevailing price at the time of execution. In practice, adhering to the terms of such a contingent trade can result in each component of the spread being away from the price of each constituent, requiring a contingent trade through exemption.

The exception should be available regardless of exercise, conversion, or intent to convert and regardless of whether the convertible or exchangeable security, upon exercise or conversion, results in a receipt of the physical security that underlies it or, instead, the cash-equivalent value.

The exception should also apply to merger arbitrage strategies which involve the simultaneous purchase (sale) of a target company's stock and sale (purchase) of an acquirer company's stock. The price relationship between these two securities is known as the "spread", and involves an exchange ratio (or exchange ratio formula). Spread trades are based on the relationship between these two company's stock prices. As with contingent trades, the relationship is known and specified at the time of the order, and the relationship stands regardless of the prevailing price at the time of execution. In practice, adhering to the terms of such a spread trade can result in each component of the spread being away from the price of each constituent, requiring a merger arbitrage exception in Rule 611.

The types of arbitrage activities described above are unique in nature and bring important efficiencies to the U.S. securities markets. Without specific exceptions to Rule 611, ability to conduct these types of trading activities would be significantly hampered, and could result in BDs exiting some of these businesses.

Reproposed Rule 600 (b)(57) should be modified to include in the definition of “protected bid” or “protected offer” certain “manual quotations,” as defined by Rule 600(b)(37), for illiquid securities, defined as stocks that trade less than an average of 100,000 shares[4] a day.

Illiquid stocks trade much differently than liquid securities and concrete empirical evidence has consistently shown that illiquid stocks have superior market quality in non-fully electronic (i.e., manual) environments. As a result, we oppose allowing automated markets/quotes to trade through manual quotes for illiquid securities. Bear Stearns made this point to the Commission in our letter dated October 11, 2004[5] and we have reiterated it in conversations with Commission staff. The fact that this issue continues to go unheeded suggests that the market structure debate has excessively focused on the most active stocks in the marketplace to the neglect of less liquid securities.

We understand the potential complexities of carving out a segment of securities for the purposes of this rule. However, we remain convinced that the quality of trading for illiquid stocks is not enhanced by mandating ‘automated quotes’ and ‘automated markets.’ We have presented data to support this viewpoint and, to date, have still not seen any evidence refuting this position. For the more than 2,150 (approximately 60%) NYSE listed securities that have an average daily trading volume of less than 100,000 shares (that “trade by appointment”), a requirement for ‘fast’ markets and ‘fast’ quotes is misplaced. For illiquid stocks, time and negotiation are two key ingredients in the liquidity formation process, and the Reproposal does not reflect this reality. In addition, given the slow frequency of quote updates, the firm quote rule should effectively ensure “certainty” of execution. We respectfully request that the

---

[4] This line drawn at 100,000 shares per day is likely too low, but is in our view, a solid minimum standard. We believe this line should be drawn at the outset of Regulation NMS implementation and that the Commission should track market quality among stocks of varying liquidity after Regulation NMS goes into effect, with the goal of raising or eliminating this manual quote exemption for illiquid stocks pending further examination.

[5] Bear Stearns letter to Jonathan G. Katz, October 11, 2004, addressing Rule No. SR-NYSE-2004 and File No. S7-10-04, Regulation NMS.

Commission include “slow” (manual) quotes for “illiquid” stocks within the definition of protected bids and offers until such time as empirical evidence demonstrates the benefits of excluding such quotes from protected status.

We appreciate your consideration of our concerns and look forward to continuing a dialogue on these issues.

Respectfully Submitted,

Bruce Lisman

Cc: The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
The Hon. Roel C. Campos, Commissioner
Annette L. Nazareth, Esq.
Robert L.D. Colby, Esq.